

E-ALERT

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Congress Passes Omnibus Financial Recovery Legislation

Earlier today, the House of Representatives passed, by a 263 to 171 vote, the omnibus financial recovery legislation that was previously passed by the Senate on Wednesday evening. The President is expected to sign the legislation into law imminently.

Emergency Economic Stabilization Act of 2008

The core of the omnibus financial recovery legislation, as now passed by Congress, is the Emergency Economic Stabilization Act of 2008 ("EESA"), the same piece of legislation that failed to pass in the House by a margin of 12 votes on Monday. The centerpiece of the EESA is the Troubled Assets Relief Program ("TARP"), which provides up to \$700 billion in funding for purchase by the U.S. Department of Treasury of so-called "troubled assets" from financial institutions with significant operations in the United States.

The EESA also continues to include provisions for an alternative government guarantee program (the "Guarantee Program") for troubled assets that Treasury would be required to establish as an alternative to TARP; extensive oversight mechanisms for both TARP and the Guarantee Program; a number of restrictions on the executive compensation of institutions that sell assets to TARP; measures to assist homeowners facing foreclosure on their home mortgages; a requirement for further legislation to recoup from the financial services industry any loss ultimately experienced due to TARP's operations; authority for the SEC to suspend mark-to-market accounting under FASB Statement No. 157; and authority for depository institutions, and their parent companies, to treat gains or losses on the sale or exchange of Fannie Mae and Freddie Mac preferred stock as ordinary income or loss for tax purposes.

The single addition to the current version of the EESA from the version rejected by the House last Monday is inclusion of a temporary increase in the federal deposit insurance limit from \$100,000 to \$250,000.

We set forth below a more detailed summary of the key elements of the EESA as passed by the House and the Senate.

Renewable Energy and Job Creation Act of 2008

Apart from the EESA, the omnibus financial recovery legislation includes the provisions from a bill known as the "Renewable Energy and Job Creation Act of 2008" that the Senate – but not the House – had previously passed. The addition of these provisions to the legislation is widely perceived as ultimately having aided its passage by Congress. Highlights from the Renewable Energy and Job Creation Act of 2008 include:

- Approximately \$18 billion in tax incentives for clean energy, including credits for wind power, biodiesel and renewable diesel fuel, and electric cars.
- An increase in the income threshold at which the alternative minimum tax (AMT) is applicable to taxpayers. It is expected that this increase

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will provide relief for over 21 million taxpayers that would otherwise be subject to the AMT.

- New tax relief measures for businesses and individuals affected by recent natural disasters.
- Extension of several business and individual tax credits and deductions that had expired or were set to expire at the end of this year, including credits for research and development and deductions for state and local sales taxes.
- Amendment of ERISA to establish parity for mental health treatment in the U.S. health care system.

Summary of the Emergency Economic Stabilization Act of 2008

The following is a summary of the key elements of the EESA, as passed by the House and the Senate:

- **Troubled Assets Relief Program** – The Secretary of the Treasury (the “Secretary”) is authorized to establish a Troubled Assets Relief Program (again “TARP”) to purchase troubled assets from financial institutions and to manage such assets.
 - TARP will be implemented by a new Office of Financial Stability within the Department of Treasury.
 - Troubled assets subject to purchase by TARP include (i) residential and commercial mortgages, and securities or other instruments based or related to such mortgages, where the mortgages or instruments were originated or issued before March 14, 2008, and the Secretary determines that their purchase would promote financial market stability, and (ii) any other financial instruments that the Secretary, after consultation with the Chairman of the Federal Reserve Board, determines the purchase of which would promote financial market stability.
 - Financial institutions eligible to participate in TARP include any bank, savings association, credit union, security broker or dealer or insurance company having “significant operations” in the United States, but exclude any central bank or other foreign government-owned institution.
 - The Secretary is authorized to purchase troubled assets from financial institutions on such terms and conditions as the Secretary determines to be appropriate, in accordance with policies and procedures to be developed by the Secretary. The Secretary’s authority to purchase troubled assets includes the use, where appropriate, of “market mechanisms,” such as auctions or reverse auctions, but also includes the use of direct purchases from individual institutions where the Secretary determines that the use of market mechanisms is not feasible and the use of such direct purchases would otherwise further the purposes of the program.
 - To implement TARP, the Secretary is authorized both to hire new personnel and to retain independent asset managers to manage troubled assets under the program.
 - The Secretary is required to manage troubled assets purchased under the program so as to “minimize any potential long-term negative impact on the

taxpayer.” To do so, the Secretary’s authority includes the power to hold troubled assets to maturity in order to maximize their value, or to sell such assets on terms and conditions, including price, as the Secretary determines to be appropriate to maximize their value (including entering into securities loans, repurchase transactions and other financial transactions involving purchased trouble assets).

- Within 45 days after enactment of the legislation, the Secretary is required to publish “program guidelines” for TARP, including with respect to mechanisms for purchasing troubled assets, methods for pricing and valuing troubled assets, procedures for selecting asset managers, and criteria for identifying troubled assets for purchase. However, the Secretary also is directed that development of administrative policies and procedures is not intended to delay commencement of TARP.

- **Equity Participation** – The Secretary generally is barred from purchasing troubled assets from a publicly traded financial institution unless he obtains warrants to purchase common or preferred stock of such institution, or from a privately held financial institution unless he obtains senior debt in such institution.

- The Secretary has authority to determine the terms and amount of such warrants or debt, but at a minimum they must provide, as the case may be, for “reasonable participation” in the equity appreciation of the institution or a “reasonable interest rate premium.”

- The Secretary has authority to sell, exercise, or surrender any warrants or senior debt instruments obtained.

- The Secretary has authority to establish exceptions to the prohibition on the purchase of troubled assets without obtaining warrants or senior debt from the selling financial institution, but such exceptions cannot exclude a selling institution if its cumulative sale of troubled assets to TARP exceeds \$100 million.

- **Graduated Purchase Authorization** – The Secretary is given immediate authority and funding to purchase and hold up to \$250 billion of troubled assets through TARP.

- Upon written certification by the President to Congress, such funding authority will be increased to \$350 billion.

- Upon a further submission by the President to Congress, such funding authority will be increased by an additional \$350 billion to \$700 billion, unless Congress enacts a joint resolution of disapproval within fifteen days after receipt of the President’s submission.

- **Alternative Government Troubled Assets Guarantee Program** – Assuming the Secretary proceeds to establish TARP, the Secretary is then also required to establish a program to guarantee troubled assets originated or issued prior to March 8, 2008 (the “Guarantee Program”).

- In establishing the Guarantee Program, the Secretary has authority to develop the terms and pricing of the guarantees provided, including by category or class of troubled assets to be guaranteed.

- Premiums for guarantees are to be collected from financial institutions participating in the Guarantee Program, with premiums to be set by the Secretary at a level necessary to create sufficient reserves to meet anticipated claims.
- Premiums collected are to be deposited into a new Troubled Assets Insurance Financing Fund, and the amounts deposited in the Fund will be used to meet obligations on the guarantees provided to participating financial institutions.
- **Program Oversight** – A number of mechanisms for the oversight of TARP and the Guarantee Program are included.
 - The Secretary is required to report regularly to Congress with regard to implementation of TARP and the Guarantee Program, including periodic reports with respect to transactions undertaken, the pricing mechanisms for such transactions, and the impact of the programs on the financial system.
 - A Congressional Oversight Panel (the “COP”) is established to report periodically to Congress on the TARP and Guarantee Programs as implemented by the Secretary, including the effect of the programs on the financial markets and financial institutions. The COP will have five members (not necessarily members of Congress), one member each appointed by the Speaker of the House, the majority leader of the Senate, the minority leader of the House, and the minority leader of the Senate, and one jointly by the Speaker of the House and the majority leader of the Senate.
 - A Financial Stability Oversight Board (the “FSOB”) is established with general responsibility for reviewing the Secretary’s exercise of his authority with respect to both TARP and the Guarantee Program. The FSOB will also have five members, the Chairman of the Federal Reserve Board, the Secretary, the Director of the Federal Housing Finance Agency, the Chairman of the SEC, and the Secretary of HUD. Among other things, the FSOB is required to report semi-annually to the Congress and the Congressional Oversight Panel on the Secretary’s exercise of his authority with respect to both programs and the effect of the Secretary’s actions in this regard.
 - The Comptroller General of the United States will be responsible for ongoing oversight of the performance of TARP, including any asset managers or other agents retained by TARP, and also for conducting an annual audit of TARP’s financial statements.
 - A Special Inspector General will be appointed for TARP and the Guarantee Program, and will be required to report quarterly to Congress on his oversight of the programs.
- **Executive Compensation** – A number of restrictions are placed on the executive compensation of institutions that sell troubled assets to TARP.
 - If the Secretary purchases troubled assets directly from a financial institution due to the fact that no bidding process or market prices are available (presumably because the institution is in danger of failing) and obtains an equity or debt position in the institution (see above), the Secretary must require the institution to comply with “appropriate standards” for executive compensation, including compensation limits that preclude incentives for executive officers to

take “unnecessary and excessive risks,” provisions for the recovery of previously paid bonuses or other incentive compensation that were based on materially inaccurate earnings, and prohibitions on making any golden parachute payments to senior executives. These limitations must remain in place so long as the Secretary, through TARP, holds an equity or debt position in the financial institution.

- A financial institution that sells more than \$300 million in troubled assets to TARP will not be allowed to deduct for federal tax purposes more than \$500,000 in annual compensation to each of its chief executive officer, chief financial officer and three other highest paid executives for those taxable years in which the institution’s sales of troubled assets to TARP exceeded the initial \$300 million threshold. (For purposes of the initial \$300 million threshold, assets sold by an institution directly to TARP, as opposed to through an auction or other bidding process, will not be counted.)

- A financial institution that sells more than \$300 million in troubled assets to TARP will not be able to make any so-called golden parachute payments to covered officers – again, the institution’s CEO, CFO and three other highest paid executives – during the period that authority for the program remains in effect (see below); and such an institution also will be prohibited during such period from entering into any new employment agreements with senior executive officers that provide for golden parachute payments in the event of involuntary termination, bankruptcy filing, insolvency or receivership.

- **Residential Mortgage Assistance** – A number of steps are required in an effort to assist homeowners facing possible default on their mortgage loans and foreclosure.

- The Secretary is required to “encourage” the servicers of residential mortgages purchased through TARP, or backing securities purchased through TARP, to take advantage of existing programs that are available to “minimize foreclosures.”

- The Secretary is required to coordinate with the FDIC and other federal government entities that hold troubled mortgage assets to identify opportunities to acquire “classes of troubled assets” that will enhance the Secretary’s ability to improve mortgage loan modification and restructuring processes.

- The Secretary is required to consent, “where appropriate, and considering net present value to the taxpayer,” to reasonable requests for loan modifications and other loss mitigation measures.

- **TARP Loss Coverage** – If at five years after enactment of the legislation TARP shows a net loss – that is, the program’s liabilities exceed its assets – then the President will be required at that time to submit to Congress a legislative proposal to recoup from “the financial services industry” an amount equal to TARP’s shortfall so that the program does not add to the deficit or the national debt.

- **Program Termination** – Authority for TARP and the Guarantee program will terminate on December 31, 2009, but the Secretary may extend such authority until two years from the date of enactment by written certification to Congress. Also, such termination will not affect the Secretary’s authority to hold and manage

troubled assets that were purchased, or were subject to a commitment to purchase, prior to the termination date.

- **Other Provisions**

- The SEC is authorized to suspend Financial Accounting Standards Board Statement No. 157 – mark-to-market accounting -- for any registered securities issuer or for any class or category of transaction, if the Commission determines that it is in the public interest and consistent with investor protection to do so.
- Depository institutions and their holding companies will be allowed for federal tax purposes to treat gains or loss from the sale or exchange of Fannie Mae and Freddie Mac preferred stock as ordinary income or loss where either they held such preferred stock on September 6, 2008, or they sold or exchanged such preferred stock on or after January 1, 2008, but before September 7, 2008.
- For the period from date of enactment of the legislation through December 31, 2009, the federal deposit insurance limit is increased from \$100,000 to \$250,000. The Federal Deposit Insurance Corporation ("FDIC") is expressly directed not to take this temporary increase in the deposit insurance limit into account in setting assessments on FDIC member institutions. At the same time, the FDIC is given unrestricted authority to borrow from Treasury, to the extent necessary, to effect this increase in deposit insurance coverage.

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Attorneys in Covington's Financial Institutions Group advise a wide range of clients on financial services and banking legislation. The Financial Institutions Group's expertise derives from advising clients on the impact of such legislation over the course of the past three decades. Please do not hesitate to contact any member of our Financial Institutions Group, including the undersigned, should you have any questions.

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